

### How Leaders Can Stop Corona from Undermining the EU: The Health and Economic Crises Require Coordinated Handling

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# DGAP POLICY BRIEF

## How Leaders Can Stop Corona from Undermining the EU

### The Health and Economic Crises Require Coordinated Handling



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The coronavirus pandemic, and the resulting severe economic disruptions, can only be effectively tackled with a European and global response. The degree of integration and interdependence between member states – economically, politically and socially – means that in dealing with the virus and its economic effects, the EU is only as strong as its weakest part. Governments have to devise a more forward-looking, collective response. Hesitation and the failure to tackle the problem collectively will increase the losses – in terms of lives, economic wellbeing, political stability and EU unity.

- The European Council video call on the coronavirus of March 10th, 2020 was disappointing. European governments need to implement a coordinated health response that sets the frame for comprehensive testing, quarantine, and social distancing measures in order to delay and minimize the spread of the virus.
- Leaders need to ensure that no health system is entirely overwhelmed. This includes organizing shared new supply and stock and sharing health resources.
- An effective economic response to the supply and demand shocks caused by the pandemic as well as to financial market turmoil require coordination and more ambitious EU instruments. The ECB could play a more central role than it has so far, but the response also has to be first of a fiscal nature.
- The EU should facilitate an international response that avoids several waves of the pandemic, limits wealth losses and supports the poorer countries. This, however, first requires a coordinated approach internally.

## PRIORITIES FOR EUROPEAN LEADERS

The COVID-19 pandemic is now spreading so rapidly that epidemiologists expect up to 70% of the world population to be affected. Figures on the mortality rate of this infection vary greatly from country to country as testing is not comparable (See Figure 1). But the rate seems to be higher than the seasonal flu (with an average mortality rate of about 0.1%). It is lower, however, than the deadliest epidemic in history, the Spanish flu of 1918, which killed up to 100 million globally in 15 months (with a mortality rate of roughly 3%).

Governments have slowly accepted the inevitability of the health crisis, but still seem uncertain about the right political and economic response. Hesitation, however, greatly increases the losses. A pandemic of this scale, along with severe economic disruptions can only be addressed collectively.

European governments have to tackle three simultaneous policy challenges both at home and collectively.

- The first and foremost task is to devise a health and containment strategy that serves to slow down the epidemic and avoids the implosion of health systems.
- Secondly a comprehensive economic and financial response to the unfolding supply and demand shocks, should include forward looking flexibility in order to stabilize financial markets, provide liquidity to companies and to protect jobs.
- Thirdly, Europeans should take a lead in ensuring determined international cooperation in health and economic policy.

If they fail, the coronavirus will have tremendous health, economic and political consequences. It is not a given that Europe will be able to tackle the challenges internally in a cooperative way. For both health and economic policy, there is a bad and a more optimistic scenario. Which one materializes depends on major policy choices to be taken immediately.

FIGURE 1: COVID-19 TESTING PER CAPITA

COUNTRY/ PROVINCE	POP. IN M	# CASES (AS OF MAR. 13)	# TESTED (AS OF)	TESTS PER MILLION PEOPLE
Germany	82.8	3,117	N/A	N/A
Spain	46.7	4,073	N/A	N/A
US*	329	1,832	1,707 (Mar. 8)	5
Japan	127	701	8,411 (Mar. 4)	66
France	65.2	2,876	11,895 (Mar. 5)	182
UK	67.8	609	23,513 (Mar. 8)	347
Netherlands	17.1	428	6,000 (Mar. 7)	350
Israel	8.6	126	3,451 (Mar. 8)	401
Italy	60.5	15,113	49,937 (Mar. 8)	826
Guangdong, China	113.5	80,815	320,000 (Feb. 28)	2,820
South Korea	51.3	7,979	189,236 (Mar. 8)	3,692

\* Based on CDC and does not include accurate test counts performed at state, local, private, and commercial labs. US Census Bureau, World Population Review, CDC, FDA, KCDC, UK Dept. of Health and Social Care, Italian Ministry of Health, Japan Ministry of Health, Labour, and Welfare, Netherlands National Institute for Public Health and the Environment, WHO | Worldometers.info | March 2020

## CONTAINING THE EPIDEMIC AND PROVIDING HEALTH CARE TO THE ILL

The World Health Organisation (WHO) has so far managed to provide relevant guidance on suitable containment measures. But Europe is lagging behind in the implementation of these measures. Italy stood out early as a strongly infected country, which may be the result of a bias because it has conducted far more testing than the rest of Europe as Figure 1 illustrates. Observing the case, some governments may – at least temporarily – have decided to hide behind the appearance of lower levels of infections to delay action and European cooperation. Others may simply have underestimated the scale and scope of the pandemic.

The Council meeting of Health Ministers on March 6th, 2020 did not come up with a sufficient joint response. The fact that some member states maintained national export bans on medical devices such as protective masks shows that, as soon as the coronavirus spreads, governments opt to protect their own citizens over European solidarity. Politically, this sends a dangerous message and is very reminiscent of the early days of the euro crisis where national responses to save banks ended up fuelling rather than containing contagion.

The European Council video call on March 10th, 2020 meanwhile agreed to exchange relevant information to help limit the spread of the virus, work on the provision of medical equipment and promote research, including for a vaccine, but failed to take a common line on testing, containment, quarantine and social distancing across the EU.

### Scenario 1: Lack of political coordination, prolonged crisis

There are two scenarios going ahead. In a bad scenario different levels of testing, differing degrees of transparency around the number of cases and varying containment strategies provoke an intensification of the health crisis. In some member states, public authorities prefer to delay aggressive containment and social distancing measures and hoard medical supplies until they see enough cases at home. By the time cases are known and documented, it might be too late for more aggressive containment measures to stem the epidemic.

This disjointed approach increases the chance that national health system cannot cope with the load, as is the case in certain regions of Italy. If medical care

cannot be provided, this will unnecessarily increase the death toll, prolong the health crisis and may undermine political stability. As the case of Hungary shows, some leaders may use the health emergency to fasten their authoritarian grip of power. Other, like Italy, perceive a striking lack of European solidarity with possibly lasting effects on public opinion and trust levels. Countries whose authorities have been the slowest to respond will be more impacted for longer they risk spreading the virus back to those who have taken appropriate steps early. As a consequence, more borders may be pulled up, also within the EU. An uncoordinated approach increases the chances that the pandemic will come in several waves and that it will cause more substantial health damage and economic disruptions (see below).

### Scenario 2: A cooperative handling of the health emergency

It is therefore urgent that the EU aims for a second scenario and immediately comes up with a common approach to testing, social distancing measures and quarantine, which remain the most effective way to slow down the spread of the epidemic (see Figure 2), avoid resurgent waves caused by an excessively rapid lifting of containment measures and protect national health systems from reaching saturation point. A European framework would help governments as well as regional and local authorities to come to grips with the risks on the horizon and to take bold and in part unpopular measures early on, rather than waiting for the pandemic to visibly spread.

As it is politically difficult to lift export bans on urgently needed health equipment like face masks and respiratory aid devices unless countries have full stocks in a damage control phase, a joint procurement and distribution mechanism based on a defined set of criteria, for instance for imports from China, should be established. By organizing such imports collectively, the risk of increasing political dependencies with countries that are in a fragile situation is reduced.

Achieving this coordinated response in 27 countries and protecting more than 500 million people would help strengthen Europe's coordination ability in the economic realm, too. It is unlikely that we will see a fully coordinated economic and financial response, if we don't share the sense of a common health threat and a common health response and prove that the EU upholds its underlying principles and values even

in times of unprecedented challenges. Such a response would also demonstrate to the rest of the world that international coordination can be achieved.

This requires understanding that, just like when crises hit the euro area, Europe is as weak as its weakest part: If one European country is submerged by the pandemic and its health system is unable to cope, it maximizes the chance of a spread to other European countries. The decision by the Italian government to impose severe containment measures on the entire population is commensurate with the strength of its health system and is appropriate. It should in fact be politically supported and matched in the rest of Europe not only out of solidarity, but out of self-interest.

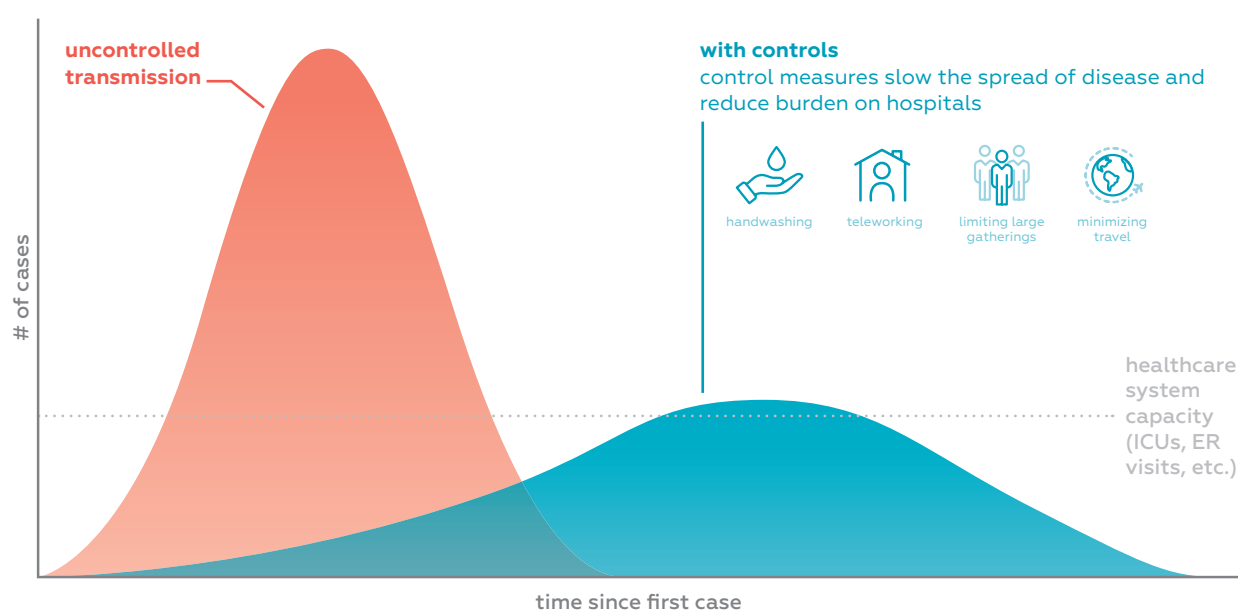
## STABILIZING THE EUROPEAN ECONOMY AND CONTAINING MARKET PANIC

Second, the economic and financial shock cannot be addressed by member states alone. Recent market turbulence was initially caused by concerns about the

spreading virus contagion and resulting value chain disruptions, but now containment measures will also have a profound and lasting economic effect.

Political leaders have so far left financial actors in uncertainty. The G7 has only released a timid communique. The 24 Finance Ministers and Central Bank governors representing the IMFC members held a conference call on March 4th, 2020, but stayed shy of issuing a joint statement. The European Council convened on March 10th, 2020 agreed virtually nothing concrete on the economic response other than a vague promise to coordinate. The European Commission's announcement for a Coronavirus Investment fund of EUR 25bn is an order of magnitude too small to matter. The US, which used to be an anchor of international crisis management, has meanwhile become a drop-out. The Trump administration initially treated the pandemic as a potential hoax and may now need to acknowledge that its health system is profoundly unable to cope with an epidemic of this nature. The consequence is likely to be an inward-looking US administration, something that is particularly harmful for an effective handling of the economic and financial repercussions of the crisis. The recent decision to ban flights to and from

**FIGURE 2: LOWER AND DELAY THE EPIDEMIC PEAK**



the Schengen area is a testament to the potential retrenchment that we will likely see more of.

**Scenario 1:**  
**Economic crisis, single market disintegration, financial melt down**

In a bad case scenario, the current lack of a forceful and coordinated political response to the economic repercussions will provoke more financial contagion. Since the Coronavirus emerged in China at the end of last year, the economic effects have spilt into Europe, first by a disruption of supply chains. Right now, European economies face a supply side shock as factories close down and people go on sick leave. This is now compounded by a demand side shock as containment, quarantine and social distancing cause a drop in travel, tourism and consumption across the board. Finally, financial market distress is fuelling a confidence shock that affects investment decisions and credit availability.

Given the absence of concerted action, European countries could take aggressive decisions to limit their own economic loss, ration certain products – as is already being done for certain pieces of health equipment – and close down internal borders not only for individuals but also for goods. Travel restrictions between EU countries based on uncoordinated assessments of the actual health risks hamper the free movement of people, goods and services, which in turn undermines the functioning of the single market and weighs on companies that have assumed the four freedoms of the single market as a given.

Some may decide to limit their fiscal response to trying to adhere to the Stability and Growth Pact and avoiding financial distress on the government bond markets. Others could decide to lift prudential measures and capital adequacy rules that the European regulator has imposed on European banks. This breakdown in coordination would mean a deeper economic shock, a certain and protracted recession, fuelling disintegration of the single market and potentially destabilizing our economy and financial system durably.

As a result, and because of the potentially inadequate economic policy response, a fully-fledged self-fulfilling crisis could develop. Ripple effects can already be seen in certain subsets of the financial sector. In the oil market, Saudi Arabia and Russia are using this crisis to start a war for market share inside OPEC risking a real collapse in oil prices. American oil compa-

nies may be heavily affected; highly leveraged energy producers are risking bankruptcy by the dozens. This could send financial markets into a tailspin.

At a moment of global vulnerability, the unpredictable Trump administration could further aggravate the situation, namely by challenging the US dollar liquidity provision via the Federal Reserve international swap line network which is central for global financial stability. Dollar liquidity shortages may cause financial markets to break.

**Scenario 2:**  
**Cooperative and flexible crisis management, new impulse for completing eurozone**

But the worst is not inevitable, European policy makers could draw both the lesson from aggressive containment measures taken in the recent crises in the financial markets and the euro area and acknowledge that measures taken individually by governments may not only increase contagion and distress, but can actually undermine the governance set-up of the euro area causing lasting harm. They may go even further, as has happened in the previous crises in the

**The Corona Response Investment Initiative**

is designed to support SMEs, health care systems, labor markets and other vulnerable parts of the economy.

In order to rapidly mobilize EUR 25bn of European public investment to cope with the consequences of the crisis, the Commission will propose to waive this year the obligation to request repayment of unspent pre-financing for European Structural and Investment Funds currently held by member states.

The member states will be obliged to use these amounts to accelerate their investments under the Structural Funds. This will be used for national co-financing they would normally have had to provide themselves to receive the next tranches of their structural fund envelopes. Given the average co-financing rates in the member states, the EUR 7.5 bn can trigger the release and use of some EUR 17.5 - 18 bn of Structural Funds across the EU.



eurozone, namely that crisis management went hand in hand with a strengthening of the institutional set-up of the currency union.

In this scenario, governments opt for collective action. They can start by building on the Corona Response Investment Initiative (see box), but increase the scope, and propose a common framework across EU countries that could include, for instance, household and corporate tax relief, social contribution cuts for workers, mandatory paid leave, paid partial unemployment and credit/mortgage holidays.

They could also provide larger amounts of lending through the European Investment Bank, in particular to those countries that do not have their own promotional bank like the Kreditanstalt für Wiederaufbau (KfW) in Germany and Caisse des Dépôts in France. Such support should go in particular to those countries with limited fiscal space or poorly capitalized banking systems.

Moreover, governments agree to apply the flexibility that the European fiscal framework allows in exceptional circumstances outside of member states' control. These should be invoked at the next Eurogroup meeting and guidelines should be offered as to the fiscal measures as well extraordinary spending and stipends to counter the supply and demand blow.

The European Central Bank, in this better scenario, plays a decisive role as well on three fronts:

- ensuring financial stability and the well-functioning of markets,
- loosening monetary to support the private sector and enable fiscal policy to play its role in full
- securing the best possible level of international cooperation.

Financial stability can be achieved by target asset purchases and long-term refinancing operations. Monetary policy needs to allow governments to meet their financing needs and expand fiscal policy. To this effect, the ECB could expand the current PSPP programme and ensure that government bond spreads do not limit the ambitious and collective fiscal response it is calling for. This might require the use of precautionary lending programmes by the ESM combined with OMT if necessary. Finally, the ECB must be at the forefront of international efforts

for coordination between central banks to guarantee financial stability and liquidity provision, which the new ECB President is probably the best possible person to undertake given her experience at the IMF. The EU should also try to mobilize its own resources and use existing instruments that can be used to allay economic shocks. Many workers will be forced into a temporary/partial unemployment and these could be in part financed via a European vehicle, which could form the prelude for a future European unemployment insurance scheme. If the EU achieves this level of coordination, it will not only successfully minimize the economic damage, it will also help limit the hysteresis effect of this crisis and accelerate the ensuing recovery.

## Corona is a large-scale stress test to the eurozone and the single market

The coronavirus crisis is a large-scale stress test to the eurozone and the single market. In the best-case scenario, political leaders not only handle the crisis well, but use the momentum to further much needed steps of deepening. This includes the completion of Banking Union and moving ahead with the Capital Markets Union. Indeed, the way the coronavirus crisis plays out in financial markets and national banking sectors is a strong case in point that lasting national divisions are harmful to the proper functioning and crisis responsiveness of the euro area and the EU. A strong political message of both European solidarity and strong national interest to act in a European way needs to accompany crisis management.

### ADVANCING GLOBAL COOPERATION

Europe has a tremendous role to play on the continent as well as internationally to ensure that the spread of the disease is as limited as possible and to minimize the economic fallout. At the moment, China and

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South Korea are becoming far better models to follow but they do not have the ability to lobby for international action. If and when Europe sorts out a common approach and response, it needs to live up to its global responsibility and play an active role in achieving a global solution on both the health and economic front. The EU should also live up to its international responsibility in limiting the spread of the disease in developing countries and limiting the risks of important economic or financial fallouts for the rest of the world. On the health front, this may require sending advance teams of doctors to affected countries in the global south to ensure adequate testing, training and social distancing.

On the economic front, the IMFC, the G20 and G7 are the right fora for Europe to lobby for a more coordinated response economically as soon as it has devised its own. But it will prove difficult, because Saudi Arabia chairs the G20 and is currently engaged in a price/market war with the OPEC. Meanwhile, the US chairs the G7 and has shown with its unilateral travel ban to and from the EU, that it was neglecting international cooperation, including with its allies. The absence of international economic cooperation could limit the fiscal and monetary expansion of certain countries out of fear of free riding by the others and cooperation breakdown could make economic fallouts far worse.

The London G20 in February 2009 is probably the last thing that comes to mind as an exercise in international economic policy coordination. Yet, it played a vital role in organizing the response to the global financial crisis.

This time the virus is not of a financial origin, but it needs to be fought with the same intensity because it can have even worse effects. It is time to see if Europe has learned anything from the global financial crisis, the euro crisis and whether it can exert sufficient leadership on the global stage. Bilateral actions, possibly first with China given its successful experience in containing the virus, could be an important first step.

Regarding financial stability, the ECB has a particular role to play both in reassuring the world that it will live up to its responsibility as the issuer of a currency that is widely used internationally and that it stands ready to provide liquidity to its partners via the agreed FX swap arrangements. This commitment would reinforce the long term standing of the euro's international status. And it should maintain a close dialogue with the leading central banks, in particu-

lar the Federal Reserve as well as the Central Banks of China, Japan and the UK to ensure the highest level of coordination and the unwavering commitment of all parties, in particular the US, to sustain the existing FX swap line network.

Europe is currently a laggard when it comes to the health and economic response to this epidemic. It has a long way to go but must get ahead of the crisis now and help coordinate a global response.

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